

Office of Chief Counsel  
Internal Revenue Service  
**memorandum**

date: December 9, 2002

to: Barbara Knight  
Team Manager (LMSB audit)  
M/S W135  
Jackson Federal Bldg.  
Seattle, WA

from: Associate Area Counsel (LMSB)  
Seattle, WA

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subject: [REDACTED] ([REDACTED] - [REDACTED])

**Section 864(e)(2) interest expense allocation for CTI  
computation (FSC); netting advance payments against  
inventory**

**Our Ref: POSTUM 139509-02**

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**ISSUE**

Whether [REDACTED]'s [REDACTED] response to FSA 200201009 warrants reconsideration of the Government's position. The FSA concludes that in computing the "total value of assets" under Treas. Reg. § 1.861-9T(g) (for purposes of apportioning interest expense to the combined taxable income of its FSC) the asset value of [REDACTED]'s [REDACTED] inventories should not be reduced by advance payments.

**CONCLUSION**

No.

**FACTS**

The relevant facts are set forth in the FSA. Much of [REDACTED]'s response is directed at the following portion of the FSA's analysis:

As discussed above, the tax book value of a taxpayer's assets is equal to the taxpayer's adjusted basis in those

assets. The basis of property included in inventory is the last inventory value of such property. Section 1013 of the Code; Treas. Reg. §1.1013-1. Manufacturers must include all of the direct and indirect costs of manufacturing inventoriable goods in the inventory value. Section 263A; Treas. Reg. §§1.263A-1, 1.263A-2, and 1.471-3(c). Thus, the value of inventory increases due to direct and indirect production costs. The regulations permit manufacturers to reduce the value of property included in inventory only in circumstances where the cost to reproduce the goods or the selling value of the goods declines. Treas. Reg. §§1.471-2(c), 1.471-4(a), and 1.471-4(b). There is no provision in the Code or the regulations that permits a taxpayer to reduce its inventory value as a result of receiving payments for goods in advance of a sale. Accordingly, Parent's tax book value (i.e., adjusted basis) in inventory will be unaffected by the advance and progress payments.

#### ANALYSIS

██████'s response cites a case, a TAM, and a couple of unrelated Treasury Regulations in support of its position. Each of the authorities is addressed below.

A. Anderson Brothers Corporation v. Commissioner, 296 F.2d 627 (5<sup>th</sup> Cir. 1961), aff'g 34 T.C. 199 (1960).

Anderson Brothers involves a "total asset" determination under the 1950 Excess Profits Tax Act for a corporation involved in the construction of pipelines under long term contracts.<sup>1</sup> The specific issue concerns whether or not expenditures for uncompleted contracts represent assets only to the extent that they exceeded cash payments received (i.e., whether payments


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<sup>1</sup> Under the 1950 Excess Profits Tax Act, a taxpayer must determine the correct amount of total assets ("the sum of cash and property held by the taxpayer") it is entitled to use in determining its excess profits credit. In general, the higher the value of the assets, the lower would be the excess profits tax. Section 442 of the Act, which defines a taxpayer's "total assets", indicates that an asset "shall be included in an amount equal to its adjusted basis for determining gain upon sale or exchange...."

should be netted against expenditures).<sup>2</sup> According to the opinion, "[t]he Government ... [took] the position that expenditures made by the taxpayer on uncompleted contracts are an asset or property only so long as they have not been paid back to it." Anderson Brothers, 296 F.2d at 629. The court agreed with the Government's position and reasoned, in part:

[O]nce the partial performance has reached the point where, under the terms of the contract, the contractor-taxpayer is entitled to receive payment, the asset theretofore represented by the expenditure is now, briefly, converted into another type of asset, an account receivable, and, if the parties carry out their contract, shortly thereafter into cash.... No amount of form can overcome the substance, and no amount of theory can overcome the fact, which is that a creditor seeking to seize the property of such a contractor would not be able to reach both the item representing expenditures on uncompleted contracts and the cash sums actually paid by the owner and received on the contract in repayment of these expenditures.

Anderson Brothers, 296 F.2d at 630.



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<sup>2</sup> The typical contract provided for a contract price which was based upon specified unit prices for the various phases or classes of work to be performed. The contract further provided that either monthly or semi-monthly, the taxpayer would be paid a fixed percentage, usually 80% or 90%, of the estimated amount payable for work done during the preceding period as a partial payment, the remaining 10-20% payable upon completion of the contract. Anderson Brothers, 296 F.2d at 628.

[REDACTED]  
[REDACTED]:

[Anderson Brothers'] "Work in Progress" asset item was, the court held, to be reduced to the extent of payments. This is, of course, simply another way of saying that the partial payment constituted a true "payment" for the appropriate percentage of inventory work-in-process accomplished theretofore, and to that extent a sale had resulted with a concurrent passage of title to the property from the contractor to its customers who had paid therefor.

[REDACTED].

Anderson Brothers is materially distinguishable from this case. In Anderson Brothers, the court did not focus on the terms of the contracts; rather, it viewed the arrangement as a customer paying for particular services provided by the taxpayer (the pipe and right of way were provided by the customer). In [REDACTED] opinion, the Claims Court described this as essentially a [REDACTED] [REDACTED]. This case is not that simple. The advance payments by [REDACTED]'s customers, while perhaps equated with historic expenditure patterns, do not represent payments for any particular service or bundle of parts.<sup>3</sup> Further, as to the passage of title contemplated by the foregoing opinions, it is our understanding that the contracts at issue herein specifically provide that title and risk of loss do not pass to the buyer until delivery of the finished [REDACTED]

**B. TAM 9129001 (March 11, 1991).**

This ruling concerns the amount of interest expense that is deductible against effectively connected income (\$ 864) and, more specifically, whether the "average total value of U.S. connected assets" (for purposes of section 1.882-5) must be reduced by a reserve for bad debts. Chief Counsel concludes that the asset value of portfolio loans is reduced by such amount, even though its not otherwise chargeable to basis,

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<sup>3</sup> Hence, it cannot be reasoned that the manufactured [REDACTED], for example, is converted into an account receivable which is paid via the 5% payment made 18 months prior to delivery.

because - (i) the reserve is directly related to the value of the assets (i.e., the portfolio), (ii) the reserve amount is otherwise deductible under section 585, and (iii) the reserve represents a decrease in the amount of capital committed to the portfolio.<sup>4</sup> While the ruling generally supports the notion that "netting" may be appropriate in certain situations, it is distinguishable by reason of (ii) and (iii). See also I.R.C. § 6110(k)(3) (letter rulings have no precedential value).

**C. Treas. Reg. sections 1.861-12T(f) & 1.263A-11(c).**

██████'s reliance on these regulations is generally strained and unpersuasive. The section 861 regulation (involving assets funded by disallowed interest) is unrelated to this issue. Also, the notion that the advance payments are essentially "implicit interest element[s]", analogous to the interest in Treas. Reg. § 1.861-12T(f), is misplaced. Our original request for Field Service Advice explains why Treas. Reg. § 1.263A-11(c) does not support ██████'s position.

**D. GAAP.**

██████ next posits the following GAAP-related argument in support of netting:

Inventory is a unique asset in that the starting point for determining the basis of inventory is generally the taxpayer's balance as determined under GAAP, provided the determination clearly reflects income.... Given that the measure of the basis of inventory begins with a taxpayer's determination of its inventory in accordance with GAAP, it is proper to determine the tax book value of inventory in a manner that is consistent with GAAP methodology. In particular, ██████ has consistently determined its GAAP inventory by treating the amount of customer advance and progress payments received as a reduction or offset to gross inventory.

Our response to this is twofold. First, ██████ should

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<sup>4</sup> On the latter point, the ruling provides: "In a manner analogous to a reserve for depreciation, the amount of a bad debt reserve reflects diminution of capital: a depreciation reserve represents economic waste of a depreciable asset, a bad debt reserve represents capital anticipated to be irreclaimable by a debtor."

provide specific GAAP authority for its inventory offset before we can fully analyze this argument. Further, even if GAAP supports netting, financial and tax accounting treatment often diverge. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-544 (1979); Challenge Publications, Inc. v. Commissioner, 845 F.2d 1541, 1546 (9<sup>th</sup> Cir. 1988), aff'g T.C. Memo. 1986-36. That is, an accounting method that conforms to GAAP, but does not comply with the Commissioner's regulations, may not clearly reflect income.

**E. "FSA 200201009 is based on erroneous allegations of fact and an incorrect interpretation of the interest allocation regulations."**

██████'s first argument under this heading relates to a factual assumption in the FSA:

██████ did not use the percentage of completion method for computing CTI [as assumed in the FSA]. ██████ instead used the accrual method ..., without regard to the method used for non-FSC purposes. As a result, the portion of the FSA's analysis of advance payments accounted for under the percentage of completion method is irrelevant.

Assuming the inconsistent accounting treatment for the same contracts is appropriate, treating the subject portion of the FSA as irrelevant does not alter the position of the Service; it was essentially an additional argument in support of the conclusion.

██████'s next argument under this heading relates to the FSA's interpretation of the term "tax book value":

[T]he FSA is based on the implicit assumption that an asset's "tax book value" is, absent an explicit exception in the regulations, equal to the asset's adjusted basis .... The two terms (i.e., "tax book value" and "adjusted basis") are not equivalent, as demonstrated by the section 861 regulations which, in several instances, provide that an asset's "tax book value" is equal to something other than the asset's "adjusted basis," or is equal to the asset's adjusted basis after being reduced or increased by other amounts." [footnote omitted]

The authorities cited in support of the foregoing excerpt, relegated to a footnote, are sections of the 861 regulations

which generally involve an explicit adjustment to "tax book value" or "adjusted basis." See, e.g., Temp. Treas. Reg. § 1.861-9T(e)(2) ("An individual using the tax book value method of apportioning shall use the partnership's inside basis in its assets, adjusted to the extent required under § 1.861-10T(d)(2).").<sup>5</sup> The regulations do not undermine the statement in the FSA that "[t]here is no provision in the Code or the regulations that permits a taxpayer to reduce its inventory value as a result of receiving payments for goods in advance of a sale."

**F. Hazards of litigation.**

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<sup>5</sup> The authority cited is -- Temp. Treas. Reg. § 1.861-9T(e)(2), (3); Temp. Treas. Reg. § 1.861-9T(f)(3); Temp. Treas. Reg. § 1.861-9T(g)(2)(ii); Temp. Treas. Reg. § 1.861-12T(f).

Please let us know if you have any questions regarding the foregoing analysis and conclusion.

ls/wAm  
William A. McCarthy  
LMSB (Area 5)  
(206) 220-5951